“California’s Fiscal Future: Do We Need a Public Pension Reboot?”

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Remarks by California Treasurer Bill Lockyer

Thanks for that kind introduction. I want to thank Amy Brown for the great job she does writing, editing and provoking intelligent conversation about public pension issues in her Public Retirement Journal.

Month in and month out, she takes the driest and most tedious subjects – like what to make of the latest actuarial assumption, or how did they calculate the “ARC” for the next decade (a subject which often make billions of dollars of difference) – and turns them into consistently clear, understandable and frequently very funny observations.

Her analyses help pension practitioners and pension policymakers alike understand the stakes and the state of play on pension issues, not only in the State Capitol but throughout California.

Here’s my favorite example of what Amy can do when she really gets fired up on a subject.

It’s the commentary several months back when she provided the best and most articulate takedown of the shock-filled study done by Stanford grad students last year sponsored by David Crane and performed by the group I now call “Joe Nation and the Sons of Hoover.”

They are among the sturdy little band of financial engineers and partisans who believe that no matter how pension funds and the Government Accounting Standards Board think we ought calculate our unfunded liabilities (a method that's been working very well for about seven decades), we must now genuflect to the University of Chicago Business School – and multiply by three.

After Amy got done disassembling the parts and examining them with an electron microscope, the background, meaning, and true purposes of the new "risk-free earnings" crowd couldn't have been clearer.

So thanks, Amy, for the work you do, and thanks for inviting me.

One disclaimer: All of you know that the Treasurer is one of the statewide elected officials who hold membership on the Boards of Administration of CalPERS and CalSTRS. I want to make it clear that I am speaking today <u>not</u> as a representative of either.

Among the things I want to talk about today is retirement security and the level of benefits for future California public employees. And both PERS and STRS have adopted policies that prevent them from becoming advocates for one side or the other when it comes to changing benefits.

For those of you familiar with the decade of recriminations that followed the enactment of SB 400 and similar bills to increase benefits – which were strongly advocated by the pension funds – I think you will agree with me that PERS and STRS can best perform two roles these days: Be the honest brokers of the best and most accurate information about costs and benefit comparisons; and be the strong defenders of, and advocates for, the funding needed to keep our promises to workers and retirees, now and in the decades to come.

So today, I am speaking to you as California's Treasurer. I have a pretty good vantage point on the State of California's finances, now and for the next few years. But as a California public official, I also

believe in the principle that our nation and our state have an absolute obligation, to every American and every Californian, to ensure that when the time comes for them to put down the tools and enjoy a well-deserved retirement, those workers can live the rest of their lives with dignity and good health, and not in poverty.

I have fought for those principles for more than four decades in public office.

And in my view, nothing is more important in providing for retirement security than preserving the defined benefit pension for those who have it, and restoring and reinvigorating the defined benefit leg of the three-legged retirement stool for those across the country who have lost it in the space of a few short years.

I stand, as I always have, with those who have fought for decades to build and defend defined benefits. But as I will make clear a little further along today, I also believe that if we want to get the people of California and the nation back in our corner on these issues and also protect the interest of the present-day working families, we have to make corrective changes in all of the systems that now provide retirement security for California's public employees.

And if we need to do it, then we ought to do it – but on our terms. We must not allow the debate on retirement security to be framed by those who simply seek to eliminate altogether defined benefits, the social and economic power of public pension funds in the market, and the power of workers and their unions to be a balancing force to business and the unregulated marketplace in American life.

And if we want to do it on our terms, in California the time is now – while we have a Governor and strong majorities in both houses of the Legislature who are committed to retirement security and defined benefits.

Now let me turn briefly to a little background on California's current and future fiscal health from my perspective, as the topic in your

program suggests. After that, I'll tell you what's on my mind in terms of possible pension re-design – what I'm calling a public pension reboot. And I'll do my best to relate all that to state and local finance, policy, politics and where public policy and our own self-interest seem to come together, at least as I see it.

This Governor and this Legislature have come some way in solving our huge structural deficit problem (thanks in no small part to all of us who worked hard to convince voters to restore the majority budget vote). But we are not out of the woods. We've still got a ways to walk to get clear.

While California has seen little relief from the Great Recession, I give this year's Governor and this year's Legislature a LOT of credit for closing a $27.2 billion shortfall in the 2011-12 budget. The hard-work they put in delivering an on-time, reasonably honest budget reduced average projected annual deficits from $19.4 billion to $2.3 billion from 2012-13 through 2014-15.

The financial market liked what they saw, and that has saved taxpayers millions of dollars. We got an S&P upgrade on the State's credit outlook and positive reviews from Moody's and Fitch.

And along with a better market generally, this translated to a huge reduction in costs to sell this year's short term cash notes – a full 1 percent less than last year, 0.38 percent.

That's the extent of the good news if you depend on the California state budget. To balance that budget took $11.1 billion in cuts, with the possibility more mid-year "trigger" cuts if revenues are short of budget estimates.

How do things stand right now on whether either or both of the triggers get pulled next December? At the moment, all of us are biting our trigger fingernails, and hoping that the bottom doesn't fall out on revenues.

As to the economic forecast, we may <u>technically</u> be out of the recession, but a true recovery is simply going to take an excruciatingly long time. We likely won't get back to full employment before 2017 at the earliest. Through August, California has only recovered 16 percent of 1.37 million jobs lost from July 2007 to September 2009. We won't see single-digit unemployment before 2014; it currently remains around 12 percent.

If you are Latino in California, make that 14.3 percent.

If you are black, it's 20 percent.

If you are between 20-24 year olds it's 17.6 percent unemployment.

16-19, it's 34.2 percent.

And, that's what we call "headline unemployment." Add another 8 percent to 10 percent if we include long-term unemployed who've stopped looking for work and the chronically under-employed who would like to be full-time.

Looking geographically, California coastal regions have not been hit as hard, with Marin leading California with the lowest unemployment rate of 7.8 percent, while Imperial County exemplifies the plight of inland California with a 32.4 percent unemployment rate.

The UCLA Anderson Forecast for the second quarter of this year predicts that real personal income growth for California will sort of trudge along at rates of 1.7 percent in 2011, 3.3 percent in 2012 and 3.8 percent in 2013.

But despite all the bad news, I'm still putting my money on California. I'm optimistic about our future. We have to make good public policy and investment decisions. It may be tough and it may be slow, but if anyone can do it, Californians can. This is still the place diversity, creativity and hard work all pay off – eventually!

So, along with personal income, government revenues will rise, but <u>very</u> slowly. That's at least as big a problem for local government as it

is for the state, because nearly 70 percent of state revenues get transferred, one way or another, to local government. It'll be more than that after this year's public safety realignment.

And because if there's one revenue source in California that's worse off than any other, because of our housing market misery, it's property taxes, which will be flat or down for years until home prices recover or we go to a split roll.

SO, DO CALIFORNIA PUBLIC PENSIONS NEED A REBOOT?

What about public pensions and what they cost state and local budgets? What's the problem? Unfunded liabilities? Yes and no.

<u>No</u>, pension liabilities are <u>not</u> a problem in the sense they are so huge and insurmountable that retirees won't get what they've been promised I'm a lawyer, and I can tell you that as long as we are living under US and California constitutions, those benefits that have been earned <u>will</u> be paid.

I'm also mindful that judges, too, have been promised <u>their</u> pensions.

And frankly, if you want to look at a truly scary set of unfunded liabilities, health care for retirees is a better choice than pensions. We are systematically investing and setting aside contributions to pay off our pension liabilities. But with a few notable exceptions – the California Highway Patrol Association and a relative handful of local jurisdictions – no one else is dealing in any meaningful way with the health care time bomb.

But, <u>yes</u>, pension liabilities ARE a problem. And they are OUR problem because they are driving unacceptably high contribution rates for employers and workers too. And by OUR problem, I mean every one of us who fights to win economic justice for working people or to provide adequate public services to the people of California.

Let me state it plainly: With the current set of liabilities, and accepting as I do that 7.75 percent is a reasonable return expectation

for coming decades, starting about a year from now, the employer contribution rate for nearly everybody is going up by about 10 percent.

And it's going to stay that way for the next 20 years unless liabilities go down or investment earnings go way up, in a sustained way, well beyond our 7.75% assumption.

And that's without including the employer-employee cost for Social Security, or health care costs. As you know, health care costs have continued to defy gravity for the last decade and they now consume upwards of 15 percent of payroll with no end in sight.

For public safety employees, the taxpayer contribution is headed to the mid-40 percent range and will stay that way for at least the next two decades.

Costs that high are simply without precedent. They are off the chart by any normal measure.

And they make it tougher to provide wage increases or workplace improvements for the same present-day employees we want to help when they retire. I don't have to tell you they are hurting <u>now</u>.

That's why I'm hoping that the Governor and Legislature are going to come up with a public pension reboot that will help bring pension costs down from the stratosphere, where every dollar you want to negotiate or spend for a wage increase is now going to cost another 25 to 50 cents to pay for retirement.

Let me say again: I don't buy the "risk-free" assumption model for public pensions – never have.

In fact, as much as anything, trying to accelerate funding to meet assumptions like these is exactly what accelerated the death of defined benefit pensions in the private sector. I am convinced that is the purpose of those who are promoting it for the public sector.

But my point is that things are worrisome enough without adding a gratuitous Risk-Free Bogeyman.

Even if we were in an era of rising public revenues – which we aren't and won't be for some time – I am sure that all of us would prefer to be spending what compensation dollars there are providing more direct income to workers to help them recover from years of wage cuts, furloughs, and layoffs and less on retirement obligations.

So, when we talk about the "sustainability" of our pension funds, we need to think about it two ways:

First, there's <u>financial</u> sustainability for those who are paying for these benefits today and for the next few decades. We need to make sure we are not forcing them to forgo the ability to win good salaries and working conditions they need today more than ever.

But we also need to think about <u>political</u> sustainability.

The system we have in place for the employees who will come to work in coming years not only needs to promise adequate retirement security for them. It must also be defendable for the long haul, if necessary at the ballot box. And to do that, I believe we should start making steady progress to ensure that ultimately, our system for public employees is <u>structured</u> in much the same way most of us are now pitching for private employees.

It doesn't have to be identical. We do not and should not have to level down to the nearly non-existent benefits that now prevail for the vast majority of private sector workers. I am hopeful that the Governor's plan will take an extraordinary, exceptional retirement formula and make it merely <u>very good</u>.

I think that the system we design for new employees should end up made up of the same basic parts we think private workers ought to have:

- **Anchored in universal Social Security.**

- **With a defined benefit plan that guarantees an adequate, not extravagant, retirement when combined with Social Security.**
- **And with a solid, well-managed and perhaps annuitized defined contribution plan that holds out a strong possibility of substantially more lifetime income to add to the defined benefit guarantee.**

An important set of studies was published last month by the UC Berkeley Center for Labor Research and Education under the title "Meeting California's Retirement Security Challenge." It is both very depressing and full of promise, and all of us should set aside an hour or two to read it carefully.

Among the things the report tells us, in demoralizing detail, is that the vast majority of Californians now approaching retirement age, just as the vast majority of their fellow Americans, are <u>profoundly</u> unprepared to continue making ends meet if they stop working. And for those in the 25-44 age bracket, it's even worse.

It tells us that the median 401-k account holder is now the proud owner of the princely sum of $20,000! That and a Social Security benefit check at age 65 is your ticket to a remaining lifetime of deep poverty, even if you are lucky enough to nail down work as a Walmart greeter.

In fact, today, less than 50 percent of California private sector employees work for an employer that provides <u>any</u> kind of retirement benefit.

And the predominant retirement benefit now offered in the private sector is a defined contribution 401-k, with or without an employer contribution. Worse, only 44 percent of those who are eligible for a 401-k actually participate.

The report goes on to make clear just how ineffective defined contribution plans alone have been in providing replacement income as a supplement to Social Security in retirement.

We call the 401-k the "do-it-yourself" pension plan, and it is clearly an abject failure. For low and middle income Californians with Social Security, we are talking about replacement income in the range of 35 percent to 45 percent max.

Barely enough to subsist.

By contrast, a CalPERS defined benefit plan can easily provide, with Social Security, more than 100 percent replacement income at or after age 63 with 30 years of service, as is the case in the CalPERS "2% @ 55" formula.

In terms of the <u>political</u> sustainability of defined benefit public pensions, it is not hard to see why we are dealing with a very serious and virulent strain of pension envy.

Now the report concludes with a proposal by an outstanding labor economist, Dr.Teresa Ghilarducci, who maps out a pretty detailed idea for a voluntary California retirement system for private employees.

Under her proposal, individual accounts would be pooled, professionally managed (possibly by CalPERS or CalSTRS), credited annually with a modest but guaranteed return – perhaps a real, inflation adjusted return of 3 percent – and annuitized at retirement to generate a secure, lifelong income stream to supplement Social Security.

The rules she's proposing are a lot tighter than 401-k's on things like pre-retirement withdrawals.

Ghilarducci's analysis suggests that with an annual savings rate of 5 percent, a 40-year career, and combined with Social Security, at age 65, this benefit could replace 56 percent of final earnings. That's an idea that could begin to make a major dent in the gap between public and private workers.

Better yet, it's also scalable: If worker or employer contributions can be increased over the years, then you're really getting someplace.

What I'm thinking is that it would be a very smart political and policy move by those who want to keep defined benefit public pensions to <u>link</u> the move for pension reform to a <u>demand</u> for a meaningful retirement security option for California private sector workers like the one proposed by Dr. Ghilarducci.

It seems to me that we have the makings of one very powerful message if we are prepared to say, "Governor Brown, public sector workers and public sector managers are ready and willing to make reasonable concessions about the size and shape of future benefits, but if we do, we want California to start the work of restoring retirement security to everyone else who works for a living in our state."

The enemies of public pensions and defined benefits want to torpedo the troop transport and sink the lifeboats; I want to evacuate workers and future retirees to a safe harbor – and then go sink a few submarines!

Governor Brown has said he plans to offer a public pension reform package. I have no special insight into what he may propose. But as I have said, I hope his plan will help bring long-term liabilities down significantly and soon, so that retirement security remains adequate and defensible, and that retirement costs get lower quicker.

It sounds as if the Governor will be looking at a hybrid, including a somewhat lower guaranteed defined benefit (perhaps better integrated with Social Security than today's model for those who are covered by Social Security), and a defined contribution plan (perhaps incorporating some of the great proposals made by Theresa Ghilarducci).

I do not know whether he intends to make this an <u>option</u> for new employees, to be bargained locally separately with each employer, or whether he intends to make it a <u>mandate for all new employees</u> going forward, a much tougher political challenge.

Obviously, if cost reduction is one objective, a mandatory lower-tier is more certain and more "scorable" in calculating costs and savings.

But this is a very tough time for workers and their families. And <u>dictating</u> terms for the compensation package rather than negotiating them is generally outside the comfort zone of those who support the right to bargain.

Nevertheless, it will take some years for employee attrition alone to reduce costs even if the new structure is mandatory. So, I'm hoping that a new benefit will be both adequate for their retirement needs and inviting enough to convince other workers, not just new employees, to migrate.

If the ultimate new benefit structure is to be entirely voluntary for new employees and negotiable for their unions, I hope and believe that public employee unions will figure out and make good decisions about the immediate and long-term economic interests of their members at several thousand different state and local bargaining tables over the next few years.

I also understand the Governor is looking to place a compensation cap on benefits, so that no one could receive a benefit of more than X dollars a month.

That could make the new defined benefit package more like Social Security, which has always been weighted to provide a higher guaranteed percentage of replacement income to lower income workers.

Higher income workers would be expected to put more of their own discretionary income into retirement savings, and it's reasonable to expect that there would be employer contributions to a defined contribution supplemental plan for higher income workers as well.

The Governor has also talked about simplifying and rationalizing the very big and varied menu of benefit plans California currently offers. If we can do it, that would be a good idea.

We need a more uniform and far less complicated benefit system for California going forward, even if it continues to be administered through the various statewide and '37 Act pension funds.

It's a lot easier to explain and justify to voters and policymakers a single California public pension structure that generates a lot fewer exceptional cases that make for very bad headlines.

Finally, on the reform list, there's CalSTRS. As know, CalSTRS needs to solve a structural funding issue: When you add up the individual teachers' retirement contribution, the school district's contribution and the State of California's contribution, it's not enough to meet the annual Actuarially Required Contribution, and the fund's investment earnings can't close a gap like that.

And unlike everybody else's public pension system, the Board of Administration at CalSTRS has no authority to require anybody to increase their contribution. Only the Legislature can do that, and they haven't: Because it's very expensive; the fund won't go broke anytime soon; there's some dispute over who's responsible for paying the annual bill; and the state's own finances haven't been conducive lately to a generosity of spirit.

Like a lot of people, I am very interested to hear what the Governor has in mind for adequately funding CalSTRS. That is a must-do proposition.

I personally think the best chance to solve this problem would be to deal with it at the same time our state deals with the basic underfunding of education with new revenues, and perhaps with realigning state and local responsibilities in ways that hopefully will also improve public education.

I want to thank you again for inviting me to join you today. I appreciate the good work all of you are doing help deliver public services and in these very tough times, to maintain a vision of public service itself as a worthwhile and satisfying calling, and a vocation that is worthy of making it our life's work.

Thank you.